


2002

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## Recommended Citation

Stout, Lynn A., "In Praise of Procedure: An Economic and Behavioral Defense of Smith v. Van Gorkom and the Business Judgment Rule" (2002). *Cornell Law Faculty Publications*. Paper 761.  
<http://scholarship.law.cornell.edu/facpub/761>

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## IN PRAISE OF PROCEDURE: AN ECONOMIC AND BEHAVIORAL DEFENSE OF *SMITH* v. *VAN GORKOM* AND THE BUSINESS JUDGMENT RULE

Lynn A. Stout\*

Every year, corporate law professors across the nation present their students with a doctrinal enigma. Case law declares that corporate directors owe their firms a fiduciary duty of care. In other words, directors must manage the firm with the care of the “reasonably prudent person.” Yet the same case law holds that directors may not be held liable for negligent decisions. Instead, their conduct is tested under a different and far more lenient standard—the standard of the business judgment rule.<sup>1</sup>

The business judgment rule is perhaps best summarized as a ban against courts second-guessing the substantive quality of disinterested corporate directors’ decisions. In gauging whether or not directors have fulfilled their duty of care in a particular transaction, the rule permits judges to consider only the quality of the board’s decision-making *procedures*.<sup>2</sup>

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\* Professor of Law, University of California at Los Angeles School of Law. Much of the work on this Article was completed while I was Professor of Law and Director of the Sloan Project on Business Institutions at the Georgetown University Law Center. I would like to thank both the Sloan Foundation and the Law Center for their support. I presented a preliminary version of my argument in May 2001 at a conference on *Van Gorkom and the Corporate Board: Problem, Solution, or Placebo?* organized by the University of Delaware Center for Corporate Governance. I am grateful to the conference participants for their insights. Finally, I am especially indebted to Stuart Banner, Stephen Bainbridge, Margaret Blair, the Hon. William B. Chandler III, Mitu Gulati, William Klein, Donald Langevoort, Lynn LoPucki, Fred McChesney, Randall Thomas, and the Hon. Leo E. Strine, Jr., for their helpful comments and suggestions.

<sup>1</sup> See *infra* notes 17-20 and accompanying text (describing business judgment rule). As Judge Ralph Winter has put it:

While it is often stated that corporate directors and officers will be liable for negligence in carrying out their corporate duties, all seem agreed that such a statement is misleading. . . . [L]iability is rarely imposed upon corporate directors or officers simply for bad judgment and this reluctance to impose liability . . . has been doctrinally labeled the business judgment rule.

*Joy v. North*, 692 F.2d 880 (2d Cir. 1982).

<sup>2</sup> When the procedural requirements of the business judgment rule have been met, courts will only pass judgment on the wisdom of a board’s decision if a transaction is so disadvantageous to the firm that no reasonable person could deem it fair. See *infra* note 21 (discussing doctrine of waste); see also *Brehm v. Eisner*, 746 A.2d 244, 262-64 (Del. 2000) (suggesting that business judgment rule requires “process due care” while waste doctrine inquires into “substantive due care”). A similar standard has been suggested in a recent article by two sitting Delaware Chancellors and a former Chancellor. See William T. Allen et al., *Function over Form: A Reassessment of Standards of Review in Delaware Cor-*

*Smith v. Van Gorkom*<sup>3</sup> provides the classic example of this procedural focus. In that case, a minority shareholder of Trans Union claimed that the firm's board of directors had breached its duty of care by approving a merger in which the Trans Union shareholders would receive fifty-five dollars per share (a significant premium over the prevailing market price). To the surprise and dismay of many in the business community, the Delaware Supreme Court agreed—but not because the court believed that the board's decision to sell the company was a bad decision. Rather, the directors of Trans Union were held to have breached their duty of care because they reached their decision too hastily, without the right information, and without asking the right questions.<sup>4</sup> The Trans Union directors were found liable not for *what* they decided but for *how* they decided it.

This emphasis on process opens the business judgment rule to attack from at least two directions. The first sort of attack emphasizes what the business judgment rule supposedly does *not* do—discourage director carelessness. According to this view, the business judgment rule needs to be changed because it shields directors who follow the requisite procedures from liability even when they make reckless, foolish, and downright stupid decisions. The second type of attack centers on what the business judgment rule *does* do—create incentives for directors to adopt elaborate and costly decision-making routines (for example, scheduling longer meetings, keeping detailed formal records of their determinations, and hiring expensive outside consultants). The result, critics charge, is unnecessary delay and expense that ultimately harms the firm and its shareholders.<sup>5</sup>

Taken together, these two critiques amount to a claim that the business judgment rule imposes substantial costs on firms and shareholders without providing any offsetting benefit. In judging the persuasiveness of this claim, it is important to recognize that the second part of the critique (the charge that the business judgment rule provides no benefit) is essential to the success of the first part (the charge that the business judgment rule imposes costs). After all, one of the first lessons of economics is that some costs are worth incurring.

The notion that the business judgment rule provides no benefits rests, in turn, on an unspoken but essential empirical assumption: that there is no

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*porate Law*, 56 BUS. LAW. 1287, 1296 (2001) ("Where the business judgment standard applies, a director will not be held liable for a decision—even one that is unreasonable—that results in a loss to the corporation, so long as the decision is rational.").

<sup>3</sup> 488 A.2d 858 (Del. 1985).

<sup>4</sup> The directors of Trans Union were denied the protection of the business judgment rule because they approved the sale of the company based on a two-hour meeting in which they relied only on short oral reports by the company's CEO and CFO to establish the company's value. See *id.* at 868-70. As a result, the court found the directors had failed to inform themselves "of all material information reasonably available." *Id.* at 872.

<sup>5</sup> Hence the deriding description of *Van Gorkom* as the "investment bankers' full employment doctrine." For examples of commentary hostile to the opinion, see sources cited *infra* notes 55-58.

connection between better procedures and better outcomes. This assumption should look dubious to anyone with experience in the business world. Changes in decision-making procedures often produce changes in results.<sup>6</sup> The problem, at least from a rational choice theorist's perspective, lies in explaining *why*. Economic accounts of corporate governance generally begin by assuming that shareholders, officers, and directors are rational actors concerned only with improving their own welfare. From this rational choice perspective, penalizing directors for following poor procedures—but not for reaching poor decisions—seems silly. After all, if directors are rational and self-interested actors, imposing liability on them for failing to jump through the right procedural hoops does not give them incentive to make good decisions. It only gives them incentive to jump through hoops.

The idea of trying to encourage good results by encouraging good procedures begins to make sense, however, if we are willing to depart from rational choice analysis and, in particular, from the *homo economicus* model of human behavior that underlies it. This model recently has come under attack from many in the legal academy, as it has become fashionable to argue that people are subject to cognitive biases that impede rational decision-making and that law and policy should take this into account.<sup>7</sup> In this Article, I join the “behavioral law and economics” trend, with something of a twist. Instead of questioning the assumption that people are always rational, I question the assumption that they are always self-interested.

I argue that if we want to understand the business judgment rule, we must begin by recognizing that *the social institution of the board of directors is premised on the belief that directors are motivated, at least in part, by altruism, in the form of a sense of obligation to the firm and its shareholders*.<sup>8</sup> Although the idea that corporate participants might have concern for something other than their own gain is largely unaddressed in economic

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<sup>6</sup> I am not referring here to the much-studied phenomenon of changing the outcome of majority-rule voting by changing the order in which items are voted on. See, e.g., DAVID W. BARNES & LYNN A. STOUT, CASES AND MATERIALS ON LAW AND ECONOMICS 448-454 (1992) (discussing agenda control). Rather, I am referring to how more subtle changes in process can lead to different individual and group decisions, even when the agenda and the applicable voting rule remain unchanged.

<sup>7</sup> See, e.g., Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: The Problem of Market Manipulation*, 74 N.Y.U. L. REV. 630 (1999); Christine Jolls, Cass R. Sunstein & Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471 (1998); Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051 (2000).

<sup>8</sup> More accurately, I argue that directors exhibit “other-regarding revealed preferences.” Translated into lay terms, this means that directors *behave as if* they care not only about costs and benefits to themselves, but also about costs and benefits to others. One can hypothesize a number of subjective motives that might trigger such behavior, including guilt, ego, moral principle, fear of divine retribution, or mindless adherence to a particular social role. See *infra* notes 31-32 (discussing how apparently other-regarding behavior might provide utility). Whatever the cognitive source of other-regarding conduct, my point is that directors can and do behave as if they care about something other than their own extrinsic rewards. Moreover, this phenomenon—which I shall sometimes refer to as “altruism,” if only for lack of a better word—may be important in understanding the business judgment rule.

analyses of corporate law, social scientists outside the rational choice paradigm have developed an extensive empirical literature demonstrating that altruistic behavior is both common and predictable. In particular, numerous studies of human behavior in experimental games demonstrate that altruism is easily triggered by social context (for example, subjects' beliefs regarding *others'* needs, expectations, and behavior). These studies also demonstrate, however, that altruistic behavior becomes less likely as the personal sacrifice involved in behaving altruistically increases.

This last finding suggests a behavioral rationale for *Van Gorkom's* requirement that corporate directors "inform" themselves before they act. This requirement may play an important role in encouraging director behavior that benefits the firm and its shareholders by reducing the marginal personal cost associated with altruistic director behavior. In particular, the business judgment rule can reduce an altruistic director's *cost of comprehension* (that is, the cost of finding out what is going on at the firm and what the available courses of action and likely consequences might be) and also can reduce a director's *cost of confrontation* (that is, the cost of demanding more information from management or challenging a management-recommended course of action). The business judgment rule may thus provide a valuable second-best solution to the problem of encouraging director care in situations where courts cannot easily assess the substantive quality of directors' business decisions.

## I. THE ENIGMA OF THE CORPORATE BOARD

In addressing the puzzle of the business judgment rule, it may be useful to begin by contemplating a larger mystery: the mystery of the corporate board. Public corporations control the lion's share of profit-making activity in the U.S. economy. Public corporations, in turn, are controlled by boards of directors.<sup>9</sup> Although a number of groups—most obviously, shareholders—have equitable claims of one sort or another on the assets and earnings of the public firm, as a legal matter, the control over those assets and earnings rests firmly in the hands of the board.<sup>10</sup> In other words, directors of U.S. public corporations control tens of trillions of dollars of (mostly) other people's money.<sup>11</sup>

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<sup>9</sup> See, e.g., DEL. CODE. ANN. tit. 8, § 141(a) (1991) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided . . . in its certificate of incorporation."). Although the language of the Delaware statute suggests this is a default rule, as a practical matter a board of directors is a universal attribute of large firms.

<sup>10</sup> Although it has become commonplace for corporate scholars to focus on the shareholders' economic interest in the firm, other groups also make investments in public corporations that leave them vulnerable to director misbehavior. See, e.g., Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999) (discussing vulnerability of other groups such as managers, employees, and creditors).

<sup>11</sup> As of June 30, 2001, the market value of corporate equities in domestic corporations approxi-

Why should we expect them to exercise this control responsibly, for the benefit of the firm and its shareholders? If we only consider directors' financial incentives, the answer to this question is not obvious; financial carrots and sticks are notably missing from the boardroom. Consider the question of carrots first. Traditionally, corporate directors receive a fixed annual fee for their services.<sup>12</sup> This compensation arrangement presents a director with the following choice: either she can invest extensive time and effort to find out what's going on at the firm and then confront the firm's CEO when he has made a bad decision, or she can approve whatever the CEO proposes. Both approaches pay the same.

To remedy this lack of incentive, many firms have begun to pay all or part of their directors' fees in the form of shares of the company's stock. This development has been applauded as a means of tying directors' financial interests to those of other shareholders.<sup>13</sup> It is important, however, to be realistic about just how weak these ties often are. In large, publicly-held corporations, any single director's efforts at care are likely to have only an infinitesimal effect on the price of her firm's stock when compared with other factors such as industry shifts, broader stock market movements, and changes in technology, competition, and consumer demand (not to mention the efforts of her fellow directors).<sup>14</sup> Even when a director owns shares, on average she can expect relatively little direct personal gain from devoting time and energy to overseeing the firm.<sup>15</sup>

What about financial sticks? Corporate law imposes on directors a "duty of loyalty" that exposes them to potential personal liability if they use their corporate powers for their own pecuniary benefit. Put more bluntly, the duty of loyalty deters directors from stealing corporate assets.<sup>16</sup> But if we want directors to do a good job, it is not enough simply to discourage

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ated \$14 trillion. Board of Governors of the Federal Reserve System, Flow of Funds Accounts of the United States, Sept. 18, 2001, at 90 tbl.L.213. Although directors often own shares in the firms on whose boards they sit, the law does not require this, and in any case directors' holdings make up only a small fraction of total market value.

<sup>12</sup> ROBERT C. CLARK, *CORPORATE LAW* 108-09 (1986).

<sup>13</sup> See, e.g., Charles M. Elson, *The Duty of Care, Compensation, and Stock Ownership*, 63 U. CIN. L. REV. 649, 652-53 ("Corporations should pay their directors' annual fees in company stock . . .").

<sup>14</sup> For similar reasons, the possibility that a declining stock price might trigger a hostile takeover is unlikely to spur the average director to significant effort.

<sup>15</sup> This is especially true if the director's holdings account for only a small portion of her investment portfolio. If her holdings comprise a large percentage of her portfolio, another problem arises: the director's financial interests may diverge substantially from those of more-diversified shareholders because she is exposed to the "firm-specific" risks to which they are indifferent. See, e.g., RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 179-80 (6th ed. 1990) (discussing diversified investors' indifference to firm-specific risks).

<sup>16</sup> Unlike the business judgment rule, the duty of loyalty imposes a substantive standard of "fairness" except in cases in which the transaction at issue was approved by either a majority of the remaining disinterested directors, or a majority of the firm's disinterested shareholders. See, e.g., CLARK, *supra* note 12, at 141-262.

them from using their power to serve themselves. We must somehow encourage them to use their power to serve the firm and its shareholders. This means, among other things, that we must somehow encourage directors to use their power carefully, thoughtfully, and non-negligently.

Here the business judgment rule comes into play, in a counterintuitive fashion. Case law describes the rule as a presumption that a firm's directors have, in fact, met their duty of care. A plaintiff can only overcome this presumption if she demonstrates that the directors did not act "on an informed basis," that they did not act "in good faith," or that they did not act "in the honest belief that the action taken was in the best interests of the company."<sup>17</sup> As a practical matter, the last two elements ("good faith" and "honest belief") are presumed in cases in which directors do not have the sorts of personal conflicts of interest that give rise to duty of loyalty questions.<sup>18</sup> Whether or not the business judgment rule protects a particular board decision accordingly usually turns solely on whether that decision was "informed." In *Smith v. Van Gorkom*, the Delaware Supreme Court held that the board's decision would be deemed informed unless the directors had been not just negligent, but *grossly* negligent in failing to inform themselves, before acting, "of all material information reasonably available to them."<sup>19</sup> Disinterested directors who pass this test are insulated from liability, no matter how stupid and disastrous a course of action they choose to follow.<sup>20</sup>

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<sup>17</sup> *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985) (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)). The business judgment rule thus has essentially two parts. The first is an inquiry into subjective motivation: can the plaintiff show that the board did not act in "good faith" and with "an honest belief that their actions were in the best interests of the corporation"? The second part is an inquiry into procedure: can the plaintiff show that the directors did not "inform" themselves before acting?

<sup>18</sup> See, e.g., *id.* at 873 (noting in duty of care case focusing on whether directors were informed that "there were no allegations of fraud, bad faith, or self-dealing" and that therefore "considerations of motive are irrelevant to the issue before us").

<sup>19</sup> *Id.* at 872 (quoting *Aronson*, 473 A.2d at 812). The application of a gross negligence standard makes it significantly more difficult to establish that directors are not informed, raising the question of why we should expect directors to pay attention even to the business judgment rule's modest procedural requirements. See *infra* note 61 (suggesting some answers).

<sup>20</sup> Even if a board were found to have been grossly negligent in failing to inform itself, other barriers protect directors from personal liability. For example, in the wake of *Van Gorkom*, the Delaware legislature amended the general corporation law to allow corporations to adopt charter provisions that eliminate director liability for breach of the duty of care. See DEL. CODE ANN. tit. 8, § 102(b)(7) (1991); see also Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1790-91 (2001) (discussing other barriers to director liability, including the rules of derivative suit procedure, indemnification rights, and directors' liability insurance, and concluding that "as a practical matter, a director is more likely to be hit by lightning after leaving her board meeting than she is to pay damages").

The fact that directors are unlikely to pay damages even in situations in which they have been grossly negligent in failing to inform themselves gives rise to the question of why they might bother to meet even the business judgment rule's modest procedural requirements. See *infra* note 61 (suggesting an answer to this question).

There are several important questions associated with this focus on process as a basis for liability. First, why are courts so reluctant to inquire into the wisdom of corporate directors' decisions? Judges and jurors presented with other types of tort cases are regularly called upon to decide whether a particular defendant's conduct meets or falls short of the standard of care that would be exercised by the reasonably prudent person. Why excuse corporate directors' decisions from this sort of substantive scrutiny?

There is a standard answer to this first question. Judicial oversight of corporate directors' decisions may be undesirable because the business world is extraordinarily complex, opaque, and uncertain. As a result, it can be impossible for a court to reliably assess, after the fact, whether a board's decision was reasonable when it was made.<sup>21</sup> (As Professor and former Delaware Chancellor William Allen has put it, "the board has all the information and the courts don't."<sup>22</sup>) With the benefit of hindsight, even the wisest board decision may seem foolish if it leads to disaster, as wise decisions can in the uncertain world of business. Imposing a negligence standard on corporate directors could lead to unacceptable levels of legal error as courts both dismiss meritorious cases and award damages in cases without merit.<sup>23</sup>

So it may make sense for corporate law to discourage courts from second-guessing corporate directors' business judgments.<sup>24</sup> But there remains

<sup>21</sup> See *infra* text accompanying notes 61-62 (discussing this problem and the implications for courts' abilities to assess damages in duty of care cases). Sometimes directors may pursue a course of action so imprudent that their lack of care is obvious. In such situations, a shareholder might pursue a claim against the directors for corporate "waste." The waste doctrine permits directors to be held liable for corporate transactions in which the consideration received by the firm is "so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade." *Lewis v. Vogelstein*, 699 A.2d 327, 336 (Del. Ch. 1997) (discussing waste standard). Substance is the focus of the inquiry, not process.

<sup>22</sup> Linda Keslar, *The Architect*, THE DEAL, Feb. 13, 2001, at <http://www.law.com/cgi-bin/gx.cgi/AppLogic+FTContentServer?pagename=law/View&c=Article&cid=ZZZIH41M4JC&live=true&cst=1&pc=0&pa=0> (quoting Allen); see also *Lewis*, 699 A.2d at 336 ("Courts are ill-fitted to attempt to weigh the 'adequacy' of consideration [received in corporate transactions] or, ex post, to judge appropriate degrees of business risk."); Allen, *supra* note 2, at 1296 ("[C]ourts are ill-equipped to determine after-the-fact whether a particular business decision was reasonable in the circumstances confronting the corporation."). For further explanation of this pattern, see Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 WASH. U. L.Q. 403 (2001).

<sup>23</sup> The first sort of error undermines, perhaps fatally, the value of civil liability as an instrument for deterring director carelessness. The second leads to other evils, including fearful directors who avoid any risky enterprise and "strike suits" brought by hungry plaintiffs' lawyers who file complaints in the wake of any business failure. See *Joy v. North*, 692 F.2d 880, 886-87 (2d Cir. 1982) (citing these concerns). See generally Lynn A. Stout, *Type I Error, Type II Error, and the Private Securities Litigation Reform Act*, 38 ARIZ. L. REV. 711 (1996) (discussing both types of legal error).

<sup>24</sup> A cynic might also note that a jurisprudential rule that insulates directors from liability may also serve judges' self-interest by discouraging plaintiffs from filing or pursuing cases. See Stephen Bainbridge & Mitu Gulati, *How Do Judges Maximize? (The Same Way Everybody Else Does—Boundedly): Rules of Thumb in Securities Fraud Opinions*, 51 EMORY L.J. (forthcoming 2002) (arguing that judges



the overarching riddle of why, if directors are neither financially rewarded for care nor legally sanctioned for negligence, we should expect them to do a good job for the firm and its shareholders.

One potential answer may be that corporate directors want to do a good job because they fear not legal sanctions but “social sanctions”—loss of reputation, disapproving remarks, hostile glances, even social shunning. This possibility has attracted much attention from corporate scholars in recent years.<sup>25</sup> Yet there are a number of reasons to suspect that for most directors, most of the time, the fear of social sanctions provides only a weak motive for exercising care. As just noted, the uncertainty of the business world can make it hard for external observers to gauge whether a business fiasco reflects negligence or bad luck. Indeed, *Van Gorkom* illustrates how it can be difficult even to determine whether there has been a fiasco.<sup>26</sup> Directors also are insulated from social pressures because they reach their decisions behind closed doors, and minutes of director meetings are not public documents.<sup>27</sup> This makes it hard for an outsider to finger the party responsible for a bad decision: did the director in question propose the idea, approve it enthusiastically, or dissent? Similarly, outside the rare case in which a board decision attracts significant media attention, there seems little reason to expect that a director’s social circle would even know, much less care, about her performance in the boardroom.

For these and other reasons,<sup>28</sup> the possibility of social sanctions alone seems insufficient to explain why directors who are insulated from legal liability for negligence might bother to expend the time and effort necessary to exercise care. There also remains the question of what is gained by im-

seeking to reduce their own workload and avoid certain types of cases may favor rules that allow them to dismiss cases).

<sup>25</sup> See, e.g., Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009 (1997); David A. Skeel, Jr., *Shaming in Corporate Law*, 149 U. PA. L. REV. 1811 (2001); Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253 (1999). See generally Blair & Stout, *supra* note 20, at 1793-97 (discussing this argument).

<sup>26</sup> See *infra* text accompanying notes 61-62 (discussing difficulty of determining whether Trans Union shareholders suffered any loss).

<sup>27</sup> See DEL. CODE. ANN. tit. 8, § 220 (1991) (providing that shareholders can only inspect corporate records if they show a “proper purpose”).

<sup>28</sup> Under the *homo economicus* model, it is difficult to explain why purely self-interested observers would bother to impose social sanctions on careless directors, or why purely self-interested directors would care if they did. See Blair & Stout, *supra* note 20, at 1749 n.27, 1801-02 (discussing these questions). In theory, directors might care about their reputations because a bad reputation might reduce the likelihood of being invited to join other boards. As an empirical matter, however, it is unusual for directors of for-profit corporations to serve on multiple boards. See Stephen P. Ferris et al., *Monitoring by Directors with Multiple Board Appointments: Corporate Performance and Managerial Fraud 3* (1999) (unpublished manuscript on file with the author), available at [http://papers.ssrn.com/paper.taf?abstract\\_id=167288](http://papers.ssrn.com/paper.taf?abstract_id=167288) (reporting results of empirical study of sample of 45,000 directors that found that only 4% sat on three or more boards, and that even among the Fortune 500 companies, fewer than 20% sat on three or more boards). This suggests that the prospect of material reward through other directorships is likely to be a weak influence on director behavior.

posing on directors the purely procedural requirement that they inform themselves, before acting, of the material information reasonably available to them.

This second question is the focus of my inquiry.<sup>29</sup> I believe that to answer it—and to begin to solve the larger mystery of why we expect directors of public corporations to do a reasonably good job of looking out for the interests of the firm—we must begin by recognizing a fundamental, if generally unstated, reality of the modern corporate board. This reality is that *the social institution of the board of directors is built on the expectation of director altruism.*

## II. ALTRUISM AND ITS DETERMINANTS: SOME EVIDENCE FROM SOCIAL DILEMMAS

In a symposium devoted to corporate law, it may seem jarring to come across a word like “altruism.” This may be due in part to the common tendency to think of altruism in terms of such acts as the anonymous donation of a large sum to charity, or a healthy individual’s decision to donate a kidney to an ailing stranger.<sup>30</sup> In arguing that corporate directors are motivated in part by altruism, I am not proposing that they can or should be expected to endure such exaggerated forms of self-sacrifice. Nor am I suggesting that their altruism is necessarily directed toward any particular individual or group of individuals. Rather, I am suggesting that corporate directors try to “do the right thing”—to serve the best interests of the firm and its shareholders—even though they are not likely to reap any significant personal financial rewards if they do, or to suffer any personal penalty if they do not.

This is a far weaker and more impersonal kind of altruism than the sort associated with donating a kidney. In lay terms, it might be better described as principle, moral obligation, sense of responsibility, or sense of duty. In

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<sup>29</sup> It is worth noting two other puzzles associated with business judgment rule cases. One is the question of why, when courts refuse to hold directors liable under a negligence standard, they nevertheless insist in dicta that directors have a duty to exercise due care. See Blair & Stout, *supra* note 20, at 1791-99 (discussing this pattern and offering an explanation); see also *infra* text accompanying notes 47-48 (discussing “expressive” function of duty-of-care cases). Another puzzle is why we expect the threat of liability for failing to meet the business judgment rule’s procedural requirements to change directors’ perceived opportunity costs, given the problem of assessing damages in such cases. See *infra* note 61 (discussing this problem).

<sup>30</sup> See Amy Argetsinger, *Johns Hopkins Lands Gift of \$100 Million: Money Will Fund Attack on Malaria*, WASH. POST, May 7, 2001, at A1 (reporting anonymous donation of \$100 million); Susan Okie, *Organ Exchanges Push Boundaries; New Tactics to Attract Living Donors Raise Issues of Ethics and Altruism*, WASH. POST, June 9, 2001, at A1 (reporting that the fastest-growing group of living kidney donors consists of individuals who wish to donate to strangers, and quoting medical ethicist that “[t]he initial concern was that human beings aren’t really that altruistic and, therefore, we’re suspicious of the mental state of the donor,” but that “[i]t turns out that there are people who are that altruistic”).

The fact that economic theory, with its assumption of rational and self-interested behavior, has had a tremendous influence on contemporary corporate scholarship may also have contributed to a tendency to disregard the possibility of altruism in discussions of corporate governance.

the parlance of the economist, the phenomenon could be described as a case of "other-regarding revealed preferences."<sup>31</sup> But whatever label one prefers, altruism is the key to understanding both the social institution of the corporate board and the puzzle of the business judgment rule.

How can one go about thinking formally about altruism? Economic theory alone, with its emphasis on the *homo economicus* model of human behavior, offers little guidance in understanding whether and under what circumstances people behave in an other-regarding fashion.<sup>32</sup> Help is available elsewhere, however, in the broader social sciences literature. As an example, I would like to focus on some of the evidence on altruism and its determinants that can be found in the hundreds of studies that have been published on human behavior in a type of experimental game known as a "social dilemma."<sup>33</sup>

Social dilemma experiments are designed to place the subjects who play them in situations in which their self-interest clearly conflicts with the interests of the other players. This is done by presenting the players with payoff functions that resemble those of the well-known "prisoner's dilemma" of game theory.<sup>34</sup> As in the case of the prisoner's dilemma, players

<sup>31</sup> See *supra* note 8 (discussing revealed preferences). By employing this phrase I emphasize that I am focusing on what people *do* rather than how they *feel*. Altruistic behavior may be motivated by guilt, ego, religious training, or other concerns that lead individuals to conclude that they will feel better, subjectively, if they behave as if they care for others. Although the question of motivation is both interesting and important, it is subject to considerable debate, and in any case lies beyond the scope of my argument. Instead, I adopt a simple behavioral approach, which nevertheless permits a number of useful predictions about altruistic behavior, without need to inquire more deeply into its cognitive origins.

<sup>32</sup> It is something of a standard move for economists to suggest that economic theory does not preclude altruism; people will behave altruistically if they get pleasure (utility) from helping others, making altruism consistent with self-interest. Apart from the obviously tautological nature of this argument, it provides little or no guidance to someone trying to understand when and under what circumstances altruistic behavior is likely to occur. And as a practical matter, most rational choice analysis implicitly assumes that people in fact care only about their own welfare and not about the welfare of others.

<sup>33</sup> See generally Robyn M. Dawes & Richard H. Thaler, *Cooperation*, 2 J. ECON. PERSP. 187 (1988) (summarizing studies); Robyn M. Dawes et al., *Cooperation for the Benefit of Us—Not Me, or My Conscience*, BEYOND SELF-INTEREST 97 (Jane J. Mansbridge ed., 1990) (reviewing studies); Robyn M. Dawes, *Social Dilemmas*, 31 ANN. REV. PSYCHOL. 169, 182-188 (1980) (reviewing results of numerous studies) [hereinafter Dawes, *Social Dilemmas*]; David Sally, *Conversation and Cooperation in Social Dilemmas: A Meta-Analysis of Experiments from 1958 to 1992*, 7 RATIONALITY & SOC'Y 58 (1995) (summarizing over 100 studies done between 1958 and 1992); Toshio Yamagishi, *The Structural Goal/Expectation Theory of Cooperation in Social Dilemmas*, 3 ADVANCES IN GROUP PROCESSES 51 (1986) (summarizing results of several studies).

<sup>34</sup> An example is the "give some" game. See Dawes, *Social Dilemmas*, *supra* note 33, at 179-180 (describing typical give some game). In this game, a group of  $n$  subjects is provided with a monetary stake of, say, \$10 each. They are then asked to choose between either keeping the \$10 for themselves or contributing some portion, or even all, to a common "investment pool." The subjects are told that any money contributed to the pool will be multiplied by a factor of  $n-1$  or less, and then redistributed pro rata. Because each subject shares in the pool without regard to whether she contributes, the best strategy for the selfish player is to contribute nothing. However, the best strategy for the group requires all the players to contribute \$10.

must choose between either “cooperating,” or “defecting.” As in the case of the prisoner’s dilemma, each player maximizes her personal gains by defecting, even though the group as a whole maximizes its total payoff if all cooperate.

Rational, self-interested subjects asked to play a single round of a social dilemma game with strangers would always choose to defect.<sup>35</sup> Real people, it turns out, behave far more cooperatively. As a general rule, social scientists have found that cooperation rates in “one-shot” social dilemma experiments average about fifty percent.<sup>36</sup> This finding supports the claim that altruistic behavior is in fact quite common. But it also supports the claim that selfish behavior is common. After all, if people were always altruistic, we would observe one hundred percent cooperation rates, just as we would observe no cooperation if people were purely selfish. What determines why one person cooperates when another does not, or why the same person might cooperate in one social dilemma game and not in another?

Four decades of work and hundreds of published studies suggest an answer. *Cooperation rates in social dilemmas appear to be determined primarily by social context, tempered by considerations of personal cost.*<sup>37</sup> To the scholar accustomed to the vocabulary of rational choice, the phrase “social context” may seem unfamiliar and indeed a bit mushy. This is because social context encompasses such factors as individuals’ perceptions of others’ needs, perceptions of others’ expectations, perceptions of how others are likely to behave, and perceptions of how their own choices affect others. Self-interested actors should be indifferent to such matters unless they somehow change their own payoffs. Real people turn out to be extremely responsive to them.

Social dilemma experiments provide compelling evidence of this re-

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<sup>35</sup> When a group of subjects plays social dilemmas repeatedly with each other, it can become rational for selfish players to cooperate if they fear that if they do not, they will be punished by their fellow players’ defections in future rounds. Thus “tit-for-tat” can induce rational and selfish players to cooperate when the end-game point is unknown. See Blair & Stout, *supra* note 20, at 1762-63 & n.56 (discussing theory of repeated games). Contrary to the prediction of rational choice, however, social scientists have found that average cooperation rates are actually *lower* in repeated social dilemma experiments than in “one-shot” games. See *id.* at 1767 (offering explanation for this finding).

<sup>36</sup> See, e.g., Dawes & Thaler, *supra* note 33, at 189 (noting that subjects on average contribute 40% to 60% in social dilemma contribution games); Sally, *supra* note 33, at 62 (finding mean cooperation rate of 47.4% for sample of over 130 social dilemma studies).

<sup>37</sup> See, e.g., Dawes, *Social Dilemmas*, *supra* note 33, at 185 (reporting that cooperation rates in social dilemmas were responsive to, inter alia, both expectations about others’ behavior and calculations of personal payoffs); Sally, *supra* note 33, at 75-78 (finding in statistical survey of over one hundred studies that although cooperation rates decreased as the rewards from defecting increased, “[a]ll the other variables that should affect a selfish decider either are not [statistically] meaningful or have the opposite sign,” while “factors that should not affect a participant guided by self-interest are, in fact, quite important,” including subgroup identity, instructions from the experimenter, and the size of the loss to others from defecting).

sponsiveness. Although cooperation rates in social dilemma games average around fifty percent, this figure is highly manipulable. Researchers can raise cooperation rates significantly by telling (or even hinting to) the subjects that they should cooperate,<sup>38</sup> by taking steps to foster a sense of common social identity among the players,<sup>39</sup> by indicating that the other players in the game are likely to cooperate,<sup>40</sup> or by suggesting that cooperation would produce larger payoffs for the other members of the group.<sup>41</sup> Such variables should not change the behavior of purely self-interested actors. Nevertheless, they turn out to be extremely important in determining the incidence of altruistic behavior in experimental games. Indeed, by manipulating social variables, experimenters have been able to produce cooperation rates in social dilemma games as high as ninety-five percent (almost universal altruism) or as low as five percent (almost pure self-interest).<sup>42</sup>

It is important to bear in mind, however, that the fact that social context is a key determinant of altruistic behavior does not imply that economic factors are irrelevant. To the contrary, a second intriguing finding from the social dilemma evidence—and a finding that plays a central role in my defense of the business judgment rule—is that while people frequently choose to behave altruistically in social dilemma games in certain social contexts, they still seem to keep at least one eye on their own self-interest. Researchers have found that as the personal cost of adopting a cooperative strategy in a social dilemma increases, the incidence of cooperation declines.<sup>43</sup> In other words, when plotted as a function of personal cost, the supply of altruistic behavior is downward sloping. The higher the price of behaving altruistically, the less altruism supplied.

Taken as a whole, the social dilemma evidence offers a foundation on which to build a model of human behavior that differs in important ways from the *homo economicus* model of rational choice. In particular, the evidence supports the claim that *most people have at least two personalities or modes of behavior*. In some social situations, people predictably behave selfishly. For example, when an authority suggests they behave selfishly, when they lack a sense of common social identity with those around them, when they believe others are behaving selfishly, or when they expect their selfishness will not be too costly to others, people predictably behave as if they care only about their own payoffs. In other social situations, people behave altruistically. For example, when an authority says they should be altruistic, when they share a sense of social identity, when they believe others are also behaving altruistically, when they expect their own altruism

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<sup>38</sup> Sally, *supra* note 33, at 78.

<sup>39</sup> *Id.*

<sup>40</sup> Dawes, *Social Dilemmas*, *supra* note 33, at 187.

<sup>41</sup> *Id.* at 191; Sally, *supra* note 33, at 75.

<sup>42</sup> Sally, *supra* note 33, at 62.

<sup>43</sup> *Id.* at 75.

will greatly benefit others, people predictably behave as if they care about others' payoffs as well as their own. In the economist's parlance, they "reveal" other-regarding preference functions.<sup>44</sup> This only occurs, however, when the social conditions are favorable—and the personal costs are not too high.

### III. SOCIALLY CONTINGENT ALTRUISM AND THE BUSINESS JUDGMENT RULE

Social dilemma experiments by their very nature place the subjects who participate in them in streamlined and artificial situations. There is accordingly considerable risk associated with extrapolating from the social dilemma context to the business world. Nonetheless, if we are willing to assume that people's behavior in the lab reflects their behavior in day-to-day life to any significant extent, a number of valuable insights can be drawn from social dilemma studies. As an example, consider how the phenomenon of socially contingent altruism may help untangle the mysteries of the corporate board and the business judgment rule.

Corporate law treats directors as fiduciaries: individuals who are expected to use their control over the corporation's assets and earnings not for their own benefit, but for the benefit of the firm and its shareholders.<sup>45</sup> What's more, directors are expected to serve the firm's best interests even though there are remarkably few external incentives for them to do this—they are expected to behave, in effect, as if they have adopted an altruistic preference function. The *homo economicus* model of human behavior predicts this approach is a recipe for business disaster. Even if the duty of loyalty discourages directors from actively stealing from the firm, it is irrational for a purely self-interested director to devote significant effort to the business of directing. Shirking is the only rational response to the external incentives most directors face.<sup>46</sup>

A behavioral analysis recognizing the reality of socially contingent altruism suggests, however, that the board of directors may be a far more sensible social institution than rational choice theory implies. Social dilemma studies indicate that corporate directors, like the rest of us, likely are quite capable of altruism—if the social context supports it, and *if* the personal sacrifice involved is not too great.

Here is where the business judgment rule makes its contribution. Most obviously, case law on the duty of care may play an important role in promoting director diligence by helping to create a social framework that supports altruistic behavior. As noted earlier, one social variable that has proven important in determining the incidence of cooperation in social di-

<sup>44</sup> See *supra* notes 8 & 31 (discussing revealed preferences).

<sup>45</sup> See generally CLARK, *supra* note 12, at 123, 141 (describing directors' fiduciary duties of loyalty and care).

<sup>46</sup> See *supra* text accompanying notes 12-28 (describing directors' incentives).

lemma games is the experimenter's instructions.<sup>47</sup> It is perhaps not too great a stretch to suggest that corporate directors view judges as persons of influence and authority similar to the experimenter in a social dilemma game, and that judicial pronouncements about how directors ought to behave can thus influence directors' behavior even when not backed up by legal sanctions. This possibility supports the view of scholars who have argued that corporate law shapes directors' behavior primarily through its "sermonizing" or "expressive" function.<sup>48</sup>

In this Article, however, I would like to focus on how the business judgment rule may encourage director altruism in a second and hitherto unrecognized fashion—by reducing the marginal personal sacrifice associated with altruistic behavior. To develop this argument further, let us begin by considering the nature of the personal costs that corporate directors must incur in exercising due care. In the case of the independent corporate director (that is, the director who does not also serve as an officer or employee of the corporation), the costs of exercising care fall into two broad categories.<sup>49</sup> The first category might be labeled the *cost of comprehending*. This category includes the cost of acquiring the information necessary to understand what is going on at the firm and what the available options are, the cost of ingesting that information, the cost of asking further questions, and the cost of expending the intellectual effort needed to analyze the information and reach a reasoned decision.<sup>50</sup>

The second category of costs I shall call the *cost of confronting*. The principal costs falling into this category are the costs associated with asking

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<sup>47</sup> See *supra* note 38 and accompanying text.

<sup>48</sup> See, e.g., Blair & Stout, *supra* note 20, at 1796-97; Eisenberg, *supra* note 25; Rock, *supra* note 25. It is important to note, however, that unlike some commentators I am arguing that sermonizing works largely because corporate directors "internalize" the message of the sermon, rather than because third parties use the sermons as a guide for determining when they should impose social sanctions on wayward directors. But see Rock, *supra* note 25, at 1013-14 ("The story I tell in this Article is very much a story of how a small community imposes formal and informal, legal and non-legal, sanctions on its members."); Skeel, *supra* note 25 (discussing how corporate directors can be "shamed" by third parties into better behavior).

<sup>49</sup> The case of the director who is also an employee of the firm is more complicated, and I do not address it here except to note that there is no reason to believe that such directors are not capable of altruism. However, in some circumstances (e.g., when the board is setting policy on employee compensation), they will have more of a personal stake in how the board runs the firm, and their likelihood of behaving altruistically in deciding such matters is correspondingly lower.

<sup>50</sup> To some extent, the director may be able to shift these costs to the firm by causing the firm to hire outside experts to amass and interpret much of the relevant information. For example, in the wake of *Van Gorkom*, it has become common for boards faced with similar decisions to hire investment banks to prepare "fairness" opinions. The result is a transfer of wealth from the firm to its directors. It may be an efficient transfer, however, if investment banks that specialize in valuation questions can acquire and synthesize valuation information more inexpensively than can directors, who are not specialists. Moreover, the costs shifted to the firm may be outweighed by the benefits that flow from greater director care. See *infra* note 59 (suggesting that benefits of the *Van Gorkom* formulation of the business judgment rule likely outweigh the rule's costs).

the company's management for more information, or even challenging management's conclusions when the director does not agree with them. Such confrontation can be costly in at least two senses. First, confrontation may be costly to the director if she dislikes interpersonal conflict (as many people do).<sup>51</sup> Second, confrontation may be costly to the firm and its shareholders (and therefore also costly to the altruistic director) if it undermines cordial relations between management and the board to such a degree that it works to the detriment of the business.<sup>52</sup>

By requiring directors to inform themselves of all material information before they make a decision, the business judgment rule reduces the marginal personal sacrifice associated with both sorts of director costs. Let us begin by considering how the business judgment rule reduces a director's marginal cost of comprehending. To take advantage of the rule's protection, a director must make sure before reaching a decision that she has both acquired the relevant data and given herself an adequate opportunity to absorb it. In other words, the business judgment rule gives corporate directors an extrinsic motivation or reward for following certain procedures. Having followed these procedures—having read reports, listened to presentations, asked questions and heard answers—the only additional sacrifice the director must make to reach a careful decision is to expend the intellectual energy necessary to analyze what she has already read and listened to. In other words, *the only extra effort the director must make is to think*. It is perhaps not too optimistic to hope that for most directors this last step entails only a small personal sacrifice—small enough that we can count on some degree of altruistic behavior.

Of course, an important empirical assumption underlies this argument. This assumption is that, while the complexity of the business world keeps courts from being able to reliably measure the quality of the business decisions boards make, courts can still pass judgment on the quality of a board's decision-making *procedures*. This assumption seems reasonable. A useful analogy may be found in the case of the doctor who advises a patient to undergo immediate surgery. The patient may not be in a position to judge the appropriateness of surgery as a solution to her problems. But she ought to become suspicious if the doctor makes his diagnosis over the telephone, before she has described her symptoms, and without doing any tests. Similarly, the Delaware Court of Chancery was justified in becoming suspicious in the *Van Gorkom* case when the Trans Union board of directors agreed to sell the company based only on a two-hour meeting, held on short notice, in

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<sup>51</sup> Of course, a purely self-interested director would not mind interpersonal conflict. Casual empiricism suggests that in fact people often seek to avoid conflict with others, providing another example of other-regarding behavior.

<sup>52</sup> Again, under rational choice theory this is a mythical cost, because rational choice presumes that managers and directors are always in conflict because they are always interested in serving only their own welfare. In practice, persistent conflict between boards and managers can prove destructive to the firm. See generally Blair & Stout, *supra* note 20, at 1753-59.



which the directors asked few questions and relied only on short oral reports from the company's president and chief financial officer.<sup>53</sup>

In addition to reducing a director's marginal personal cost of comprehending, the business judgment rule can also reduce her marginal cost of confronting the firm's managers. The rule does this by giving a director an independent reason for asking questions and demanding further information—in other words, a reason other than pure distrust. In effect, it allows a director to say to the CEO: "It's not that I doubt your judgment. It's just that to protect myself, I must know all the facts." Under a rational choice analysis, allowing directors to "sugarcoat" their demands in this fashion adds no value. But once we accept the possibility of director altruism in the form of a sense of obligation to the firm and its shareholders—and once we accept that *managers as well as directors* may feel such a sense of obligation—sugarcoating becomes important.

Elsewhere, Margaret Blair and I have written at length about some of the reasons why participants in firms might want to signal to their fellow participants that they view their relationships as trust-based relationships involving mutual cooperation and vulnerability.<sup>54</sup> This work suggests how sugarcoating can allow directors to make demands of managers without unduly undermining such cooperation and trust. The underlying intuition is that, without sugarcoating, the board that challenges its CEO may inevitably send a signal that it does not view its relationship with management as a cooperative one, or that it does not expect the CEO to behave trustworthily. By altering social context, such a challenge can amount to a self-fulfilling prophecy: the manager becomes more likely to behave selfishly, because the board clearly expects him to. Increased manager selfishness, in turn, imposes greater costs on altruistic directors by increasing interpersonal conflict and decreasing voluntarily cooperative manager behavior. Thus, by giving independent directors an excuse to challenge management in a less accusatory fashion, the business judgment rule may reduce the cost of director altruism by promoting greater *manager* altruism.

The end result is that once one recognizes the empirical fact of socially contingent altruistic behavior, *Van Gorkom's* expression of the business judgment rule, derided over the years as "misguided,"<sup>55</sup> "analytically un-

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<sup>53</sup> See *Smith v. Van Gorkom*, 488 A.2d 858, 868-870 (Del. 1985). Similar considerations may explain why courts inquiring into the "fairness" of interested transactions in duty of loyalty cases often inquire not only into the fairness of the price paid, but also into the fairness of the procedure used to determine that price. See, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 ("The concept of fairness has two basic aspects: fair dealing and fair price."). When interested transactions involve unique goods, there will often be a range of prices that might reasonably be deemed fair. As a result, courts can face information constraints in judging fairness in interested transaction cases that resemble those they frequently encounter in duty of care cases. Adding a procedural component to the analysis of fairness under the duty of loyalty accordingly may offer some benefit.

<sup>54</sup> See Blair & Stout, *supra* note 20.

<sup>55</sup> Franklin A. Gevurtz, *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?*,

sound,"<sup>56</sup> a "legal disaster,"<sup>57</sup> and even as "one of the worst decisions in the history of corporate law,"<sup>58</sup> begins to make sense. The Delaware Supreme Court's decision in *Van Gorkom* displayed considerable intuitive knowledge of both the business environment and the realities of human behavior. It also proposed a clever, possibly inspired, solution to the problem of encouraging corporate directors to exercise due care in making choices in circumstances in which courts cannot evaluate the wisdom of the choices themselves.<sup>59</sup>

In championing the business judgment rule, I do not mean to suggest that *Van Gorkom* was a fair decision. To the contrary, the Delaware Supreme Court's ruling was unfair to the Trans Union board in the same sense that it is unfair for one driver to be given a ticket for speeding when others around her are also speeding and she is simply keeping up with traffic. Before *Van Gorkom*, many in the business community understood the business judgment rule as a general prohibition against director liability under the duty of care.<sup>60</sup> It was a shock to learn that the Delaware courts would in fact impose personal liability on directors for breach of the duty of care (albeit on the basis of procedural, rather than substantive, inquiry).

Nor am I suggesting there was any reason to believe that if the Trans Union board had asked more questions, sought more outside advice, or

67 S. CAL. L. REV. 287, 289 (1994) (arguing that the business judgment rule is "either meaningless . . . or misguided").

<sup>56</sup> Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477, 1478 (1984) (arguing that judicial formulation of duty of care "is both out of contact with reality and analytically unsound").

<sup>57</sup> Fred S. McChesney, *A Bird in the Hand and Liability in the Bush*, 96 NW. U. L. REV. 631, 631 (2002) ("Considered a legal disaster in 1985, [*Van Gorkom*] is judged no less disastrous today." (footnotes omitted)).

<sup>58</sup> Daniel Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437, 1455 (1985); see also *id.* at 1438 (arguing that business judgment rule lacks a "coherent theory"); CLARK, *supra* note 12, at 124 ("Is the duty of care simply gobbledygook . . . ?"); Stuart R. Cohn, *Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule*, 62 TEX. L. REV. 591 (1983) (critiquing business judgment rule).

<sup>59</sup> Of course, even if the business judgment rule's procedural focus does benefit firms by promoting greater director care, the rule may still be unwise if the corporate costs associated with compliance outweigh those benefits. I am unaware of any systematic attempt to actually measure the costs and benefits that flow from the rule, and any such attempt would face significant difficulties. See *infra* text accompanying notes 61-62 (discussing difficulties of assessing costs that flow from procedural failures). Nevertheless, I strongly suspect that while the rule does impose large costs (hiring an investment bank, for example, can cost a firm hundreds of thousands of dollars), those costs are more than worthwhile given the huge amounts of wealth at stake. In the *Van Gorkom* case, for example, the shareholders of Trans Union ultimately sold their approximately 12.5 million shares for \$55 per share. *Smith v. Van Gorkom*, 488 A.2d 858, 865 (Del. 1985); WILLIAM M. OWEN, *AUTOPSY OF A MERGER 2* (1986). If greater director care had increased that sale price by even 2%, the result would have been a nearly \$13 million benefit to Trans Union's shareholders.

<sup>60</sup> This protection appeared to be available to any director who made even the most minimal effort to fulfill her responsibilities. See, e.g., *Francis v. United Jersey Bank*, 432 A.2d 814 (N.J. 1981) (finding director to have been negligent where she failed to attend board meetings or become involved in any fashion in overseeing the firm).

taken longer to reach its decision, it might have chosen a different course of action. One of the difficulties inevitably associated with any judicial inquiry into process is that it will often be impossible, after the fact, to know with any certainty what might have happened if a different procedure had been followed.<sup>61</sup> We do not know and cannot know whether, if the Trans Union board had handled the sale of the firm differently, it would have sold the company to Jay Pritzker or to another bidder, or received a higher or a lower price. This observation highlights yet another aspect of the *Van Gorkom* decision that has attracted the critics' attention—the fact that even today, it remains uncertain whether Trans Union's shareholders in fact suffered any injury as a result of the board's decision to sell the firm at fifty-five dollars per share.<sup>62</sup>

This uncertainty about damages, however, is not due to the business judgment rule. Rather, it is due to *the underlying reality that justifies the rule*. This reality is that courts often simply lack the information necessary to assess the substantive wisdom of directors' business decisions.<sup>63</sup> Being unable to judge substance, they are left with the second-best solution of judging procedure. The empirical evidence on socially contingent altruism suggests that this might, in fact, be enough.

#### IV. CONCLUSION

In the sixteen years since *Smith v. Van Gorkom* was decided, the case has continued to puzzle and provoke. One of the most obvious questions posed by the opinion is the question of what is gained by requiring corporate directors to meet the purely procedural requirement of becoming "informed," if they are then free to make negligent or even reckless decisions. From a rational choice perspective it seems counterproductive to focus on process as the basis for liability. Instead of giving directors of public corporations incentive to act carefully, it appears to give them incentive to im-

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<sup>61</sup> This difficulty raises the question of why directors would bother to follow even the business judgment rule's minimal procedural requirements when it can be so difficult to prove damages when they fail to do so. Part of the answer may lie in the fact that the legal costs and inconvenience involved in defending oneself in a lawsuit give directors incentive to avoid such lawsuits whenever they can (and to settle claims when they cannot). It is also possible that directors systematically overestimate the likelihood of personal liability, perhaps because their lawyers encourage such overestimation in order to bolster the market for their own services. Finally, case law on the duty of care may influence director behavior not only by threatening legal sanctions, which change directors' opportunity costs, but also by sending social signals that encourage directors to adopt altruistic preferences. See *supra* text accompanying notes 47-48 (discussing argument that Delaware case law influences director behavior primarily through its "expressive" function).

<sup>62</sup> See, e.g., McChesney, *supra* note 57, at 644-45 (arguing that if the court had focused on substantive outcome rather than procedure, it was "highly unlikely" that the court would have concluded the directors were negligent); Lawrence A. Hamermesh, *Why I Do Not Teach Van Gorkom*, 34 GA. L. REV. 477, 487 (2000) (critiquing opinion on the ground that the court failed to address what damage resulted from the board's actions).

<sup>63</sup> See *supra* text accompanying notes 21-23.

pose unnecessary costs on the firm and its shareholders by adopting elaborate and expensive decision-making procedures.

The wisdom of the Delaware Supreme Court's decision in *Van Gorkom* can only be fully appreciated if we are willing to move beyond rational choice, and in particular to recognize the key role that socially contingent altruism may play in shaping the behavior of corporate directors. Extensive empirical evidence demonstrates that in experimental games, altruistic behavior is quite common—when social context supports it, and when the degree of personal sacrifice involved is not too great. If this evidence from the lab tells us anything about behavior in the boardroom, a rationale for *Van Gorkom* emerges. In brief, the requirement that directors become informed before they act may play a critical role in promoting director altruism by reducing the marginal personal sacrifice a director must make to indulge in altruistic (careful) behavior.

Far from being “one of the worst decisions in the history of corporate law,”<sup>64</sup> *Van Gorkom* may be one of the finest. Acknowledging the complexities and uncertainties of the business world, the Delaware Supreme Court had the wisdom to concede that it was unqualified to sit in judgment on the substantive wisdom of most corporate directors' business decisions. Instead, it focused on what it *could* judge—the quality and thoroughness of the directors' decision-making process. The result may be an elegant, if second-best, solution to the problem of motivating directors to use due care, a solution that focuses on reducing directors' marginal costs of comprehension and of confrontation. Director altruism can do the rest—or at least, enough of the rest to make the corporate board a viable business institution.

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<sup>64</sup> Fischel, *supra* note 58, at 1455.

